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Memorandum

FSOC Finalizes Modifications to the Systemically Important Designation Process for Nonbank Financial Companies

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On November 3, 2023, the Financial Stability Oversight Council ("FSOC") finalized amendments to its interpretive guidance on assessing financial stability risks and designating nonbank financial companies as "systemically important" (a "nonbank SIFI"). The guidance replaces FSOC's prior guidance on nonbank SIFI designations, which was most recently modified in December 2019 under the previous administration, and modifies FSOC's approach to identifying, assessing and responding to certain potential risks to U.S. financial stability. The new guidance, which is substantially identical to the guidance proposed by FSOC in April 2023, is designed to provide FSOC with added flexibility and sends a clear signal that FSOC may assume a more active role in addressing financial stability risks across the economy.

The guidance retains a two-stage nonbank SIFI designation process substantially similar to the entity designation process established under the 2019 guidance (once an entity designation is deemed potentially appropriate under the 2019 guidance). In addition, the substantive analytic factors to be evaluated by FSOC in assessing potential financial stability risks retain significant overlap with those applicable under the 2019 guidance for entity-specific determinations. However, the new guidance departs from the 2019 guidance in certain key respects in order to give FSOC additional flexibility in identifying, assessing and responding to possible financial stability risks, including:

- ***Elimination of Preference for "Activities-Based" Approach*:** The new guidance eliminates the 2019 guidance's prioritization of an "activities-based" approach for identifying, assessing and addressing potential risks to financial stability under which FSOC had previously stressed that company-specific designations would be appropriate "only in rare instances."
- ***Analytic Framework Applicable Regardless of Risk's Origins*:** While the 2019 guidance described FSOC's analytic framework for assessing entity-specific financial stability risks, the analytic framework under the new guidance will apply more broadly to FSOC's assessment of financial stability risks without regard to the origin of a particular risk (*i.e.*, whether the risk arises from widely conducted activities or from individual entities), and regardless of which authority FSOC may use to address those risks.
- ***Elimination of Cost-Benefit and "Likelihood of Failure" Analyses*:** Despite a federal district court having previously rescinded an FSOC nonbank SIFI designation in part due to FSOC's failure to assess the company's actual vulnerability to financial distress and to weigh the perceived benefits of the

nonbank SIFI designation against its possible costs, the new guidance eliminates these analytic requirements from FSOC's nonbank SIFI designation criteria.

FSOC Designation Background

The Dodd-Frank Act authorized FSOC—an interagency body created by the Dodd-Frank Act and chaired by the Treasury Secretary—to designate certain nonbank financial companies as "nonbank SIFIs," and therefore subject to supervision and regulation by the Federal Reserve, if FSOC determines that (i) material financial distress at the company could pose a threat to the financial stability of the United States or (ii) the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the company could pose the same threat. A company that is designated as a nonbank SIFI would become subject to prudential standards, which may include capital and liquidity requirements, risk-management standards, the development of resolution plans, or other regulations intended to mitigate risks to financial stability.

The Dodd-Frank Act also authorized FSOC to designate certain "financial market utilities" and payment, clearing and settlement ("PCS") activities as systemically important, which designation would result in the financial market utility or PCS activities being subject to risk-management standards prescribed by applicable federal regulatory agencies.

In addition to its designation authorities, FSOC has the authority to make formal recommendations to primary financial regulatory agencies that those agencies apply new or heightened regulatory standards to a financial activity and, if no financial regulatory agency has primary jurisdiction over a particular financial activity, to make legislative recommendations to Congress.

From July 2013 to December 2014, FSOC designated four nonbank SIFIs: American International Group, General Electric Capital, Prudential Financial and MetLife. In March 2016, however, a federal district court invalidated FSOC's designation of MetLife as a nonbank SIFI, finding that FSOC's designation process was "fatally flawed" and involved "fundamental violations of administrative law." In particular, the court determined that FSOC did not follow its own published standards for SIFI-designation: it did not assess MetLife's likelihood of failure (but simply assumed that a failure would occur), never attempted to quantify or estimate the actual consequences of a failure to the financial system, and failed to consider the costs associated with designating MetLife as a SIFI. Following the court-ordered rescission of MetLife's designation, each of FSOC's other nonbank SIFI designations were rescinded by FSOC itself. There have been no newly designated nonbank SIFIs since MetLife.

In December 2019, FSOC unanimously voted to update its nonbank SIFI designation guidance to stress that company-specific designations would be appropriate "only in rare instances" and only if a potential risk cannot be adequately addressed through an "activities-based" approach. As part of its activities-based approach, FSOC specified that it will examine a diverse range of financial products, activities and practices that could pose risks to U.S. financial stability and, if FSOC were to identify a potential risk to financial stability among such products,

activities, and practices, it would work with relevant federal and state financial regulatory agencies to address the identified potential risk.

At the time the 2019 guidance was proposed, now-Treasury Secretary Yellen (along with former Treasury Secretaries Geithner and Lew, as well as former Federal Reserve Chair Bernanke) acknowledged that "[a]ctivity-based rules, guidance, and supervision will often be the best choice to reduce risks in the system…[as] was true when [FSOC] examined a number of asset-management activities and broader risks from cybersecurity," but objected to the steps taken in the 2019 guidance that, in their view, would "neuter the designation authority."

New FSOC Analytic Framework

The new guidance includes FSOC's updated risk analytic framework describing the approach that FSOC expects to take in identifying, assessing and addressing potential risks to U.S. financial stability, regardless of whether those risks arise from activities, individual firms, or exogenous circumstances. The analytic framework is not a binding rule, but it does describe the considerations that may inform FSOC's review of, and response to, potential financial stability risks. The stated purpose of the updates to FSOC's prior guidance are to strengthen FSOC's ability to monitor, assess, and mitigate risks to U.S. financial stability, regardless of whether those risks originate from individual companies or widely conducted activities, while providing flexibility for FSOC to adapt to rapidly evolving circumstances.

IDENTIFYING POTENTIAL RISKS—BROAD RANGE OF ASSETS, INSTITUTIONS AND ACTIVITIES

The Dodd-Frank Act directs FSOC to monitor "the financial services marketplace" in order to identify potential threats to U.S. financial stability. The new analytic framework specifies that FSOC's monitoring for potential risks to U.S. financial stability may cover a broad range of asset classes, institutions and activities, such as:

- ***Financial Markets*:** including markets for debt, loans, short-term funds, equity securities, commodities, digital assets, derivatives and other institutional and consumer financial products and services;
- ***Financial Institutions*:** including banking organizations, broker-dealers, asset managers, investment companies, private funds[1], insurance companies, mortgage originators and servicers and specialty finance companies;
- ***Financial Infrastructure*:** central counterparties and payment, clearing and settlement activities; and
- ***New Developments*:** new or evolving financial products and practices, and developments affecting the resiliency of the financial system, such as cybersecurity and climate-related financial risks.

[1] The inclusion of private funds among the list of institutions that FSOC may monitor for financial stability risks was added to the final guidance after not being included in the proposed guidance.

The scope of FSOC's monitoring activities under the new guidance is substantially similar to the range of products, activities and markets subject to FSOC monitoring under the 2019 guidance. The new guidance, however, renews monitoring of individual financial institutions and financial market participants (reflecting the abandonment of the "activities-based" approach) and specifically notes FSOC's potential monitoring of certain new developments regarded by the current administration as potentially threatening financial stability, such as digital assets and climate-related financial risks.

ASSESSING POTENTIAL RISKS—VULNERABILITIES AND TRANSMISSION CHANNELS

Under the new analytic framework, FSOC's evaluation of potential threats to U.S. financial stability will include an assessment of various "vulnerabilities" that may give rise to financial stability risks, as well as various "transmission channels" through which financial stability risks may be transmitted to financial markets and market participants.

The vulnerabilities identified by the new guidance as most commonly contributing to financial stability risks include leverage, liquidity and maturity mismatch, interconnections, operational risks, complexity or opacity, inadequate risk management, concentration and destabilizing activities. The transmission channels identified by the new guidance as most likely to facilitate the transmission of financial stability risk include exposures (for which FSOC would distinguish risks arising from exposures to assets managed by a company on behalf of third parties from exposures to assets owned by, or liabilities issued by, the company itself), asset liquidation, critical function or service, and contagion.

These vulnerabilities and transmission channels are very similar to the financial stability risk factors considered by FSOC under the 2019 guidance. Under the 2019 guidance, for example, FSOC identified a list of characteristics similar to the new guidance's list of "vulnerabilities" that it would assess in its financial stability monitoring for their ability to amplify potential risks to U.S. financial stability. The 2019 guidance similarly provides that FSOC would consider the extent to which financial stability risks from a nonbank financial company's failure would be transmitted to other firms or markets through "exposure," "asset liquidation" and "critical function or service" transmission channels, and considers contagion risk as part of its "exposure" transmission channel analysis.

The new guidance builds on the 2019 guidance in some respects, including by providing an expanded list of quantitative metrics that FSOC may use to measure particular vulnerabilities of a company, market or activity. In addition, while the 2019 guidance described FSOC's analytic framework for assessing entity-specific financial stability risks to be addressed through nonbank SIFI designations (and only if FSOC were to determine that potential financial stability risks are not adequately addressed through the activities-based approach), the analytic framework under the new guidance will apply more broadly to FSOC's assessment of financial stability risks without regard to the origin of a particular risk (*i.e.*, whether the risk arises from widely conducted activities or from individual entities), and regardless of which authority FSOC may use to address those risks. FSOC's expansion of its analytic framework beyond individual company designations and removal of the deference to an activities-based approach reflects what Secretary Yellen has emphasized as "the importance of taking a

comprehensive and rigorous approach" to addressing a diverse range of financial vulnerabilities, and likely signals to financial industry participants, Congress and the primary financial regulators that FSOC may assume a more active role in assessing financial stability risks across the economy.

ADDRESSING POTENTIAL RISKS—RECOMMENDATIONS AND DESIGNATIONS

FSOC's risk-mitigation tools derive from the Dodd-Frank Act, and include interagency coordination and information sharing, formal recommendations to financial regulatory agencies or Congress for regulatory or legislative changes, and company-specific designations.

Because FSOC's available authorities are prescribed by statute, the new guidance does not affect the types of actions that FSOC would be authorized to take in response to perceived threats to financial stability. In contrast to the 2019 guidance's "activities-based" approach, however, company-specific designations would not be a "last resort" remedy under the new guidance. Instead, the guidance clarifies that FSOC may use any (or multiple) of its statutory tools, including its nonbank SIFI designation authority, to address financial stability risks that may arise from varying sources without de-prioritizing company-specific designations.

ELIMINATED ANALYSES—COST-BENEFIT AND LIKELIHOOD OF FAILURE

The new analytic framework incorporates a number of considerations that FSOC is statutorily required to consider in making a determination of whether to designate a company as a nonbank SIFI, including information regarding the company's balance sheet, leverage, exposures, funding structure and interconnectedness. The Dodd-Frank Act also directs FSOC to consider any other "risk-related" factors that FSOC deems "appropriate."

The court in the MetLife case found that, in addition to the statutorily prescribed factors, FSOC was required to analyze the likelihood of material financial distress at a nonbank financial company and whether the costs of designating a nonbank SIFI would outweigh the benefits of such a designation. In response, the 2019 guidance expressly provided that FSOC would perform both such analyses prior to making a final nonbank SIFI designation. In the new guidance, however, FSOC contends that it is not required to (and specifically states that it would not expect to) perform either such analysis in connection with a proposed nonbank SIFI designation.

In the MetLife case, the court considered and ultimately rejected arguments similar to those advanced by FSOC in the new guidance regarding the lack of a requirement for FSOC to conduct such cost-benefit and "likelihood of failure" analyses. The new guidance attempts to re-assert and, in some respects, bolster its arguments against any requirement to conduct cost-benefit and "likelihood of failure" analyses for nonbank SIFI designations. Because the government's appeal of the MetLife decision was ultimately abandoned following the change in administrations in 2017, however, it remains to be seen whether any future judicial reviews of FSOC's nonbank SIFI designation authority would find that FSOC is required to conduct such "cost-benefit" and "likelihood of failure" analyses under the Dodd-Frank Act or general administrative law principles as articulated in recent Supreme Court decisions.

Nonbank SIFI Designation Procedures

In addition to the new guidance's analytic framework for substantively evaluating potential threats to U.S. financial stability, the new guidance separately prescribes certain procedures that FSOC would generally expect to follow when reviewing a company for a potential nonbank SIFI designation. The nonbank SIFI designation procedures under the new guidance are substantially similar to those under the 2019 guidance, and retain a two-stage company evaluation process, administrative requirements for proposed and final designations, and an annual re-assessment of any final designations. As noted above, however, these nonbank SIFI designation procedures would be applied under the new guidance without being de-prioritized to an "activities-based" approach, in contrast to the 2019 guidance.

FSOC does not intend to publicly announce the name of any company that is under evaluation prior to a final determination regarding that company, but may confirm the status of a company's review to a third party if the company itself publicly announces that it is under review by FSOC.

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